No. 4043

UNITED STATES

CIRCUIT COURT of APPEALS

FOR THE NINTH CIRCUIT

In the Matter of MORRIS BROTHERS, INC., Bankrupt.

ALBERT C. SMITH,

Appellant,

vs.

EARL C. BRONAUGH, Trustee in Bankruptcy of the Estate of MORRIS BROTHERS, INC., Bankrupt,

Appellee.

APPELLANT'S BRIEF

Upon Appeal from the United States District Court for the District of Oregon.

I. N. Smith, L. A. McNary and John W. Reynolds,
Attorneys for Appellant.

John P. Winter,
Attorney for Respondent.

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APPELLANT'S BRIEF

Upon Appeal from the United States District Court for the District of Oregon.

I. N. Smith, L. A. McNary and John W. Reynolds,
Attorneys for Appellant.

John P. Winter,
Attorney for Respondent.

STATEMENT.

The claim of appellant Albert C. Smith was presented against the bankrupt estate of Morris Brothers, Inc., and, upon objections filed by the Trustee, was heard before the Referee and entirely disallowed. The claim was for money of which claimant had been defrauded through misrepresentations and pretended sale to him of preferred stock in Morris Brothers, Inc. Claimant tendered his worthless stock certificates for cancellation and claimed two thousand dollars ($2,000.00) of which he had been defrauded, with interest thereon, and also asked that he be awarded a lien on certain bonds and their proceeds which he identified as representing the funds so obtained from himself and from certain others by the same fraudulent means. The decision of the Referee was, on claimant's petition, reviewed by the District Court for the District of Oregon, Honorable Charles E. Wolverton presiding, and was modified. The claim was allowed, but the lien on specific bonds and other proceeds was denied, and it was decreed that appellant's claim should be deferred in payment until all general claims not of this same class should be paid in full. From this decision the claimant appeals to this Honorable Court.

The facts upon which Smith's claim were based are so clear as to be beyond dispute. A brief statement of them will be necessary of an understanding of claimant's position and of the Court's decision.

On or about the 31st day of July, 1919, Smith was approached by the agent of Morris Brothers, Inc.,

and was solicited to purchase preferred stock of Morris Brothers, Inc., and it was falsely stated to Smith

1st: That there was fully paid, common stock of the company, aggregating $500,000.00, and that the company had that much assets in cash or its equivalent.

2nd: That the company was a prosperous, going concern, able to pay to claimant as dividends on preferred stock, at least as large returns as claimant was then receiving on certain municipal bonds, which claimant owned, which bonds were presently maturing.

3rd: That because the company was in such prosperous condition, the preferred stock of the company was better as an investment than the municipal bonds then owned by claimant.

4th: That such preferred stock could be easily sold and would pay 8 per cent per annum dividends, of which 6 per cent dividends were guaranteed.

5th: That when the preferred stock was fully sold the company's paid-up capital would be $1,000,000.00.

The truth concerning such representations was not discovered or discoverable by claimant until **after** the filing of the involuntary petition in Bankruptcy against the company, as the certificate of preferred stock in the NEW corporation — Morris Brothers, Inc.—provides.

(Transcript, 66): **"It is expressly stipulated and agreed by and between the holders of preferred stock and Morris Brothers, Inc., that the holders of pre-**

ferred stock shall have no vote in the corporation.”

And further, because Smith was paid money as **“dividends”** on the preferred stock, while he held only an interim certificate therefor, and also after the stock was delivered to him, thereby lulling him with a sense of security as to his investments.

After the petition in Bankruptcy was filed, Smith then first learned of the true facts, which are and were:

1st: That Morris Brothers, Inc. (the old company) was in existence when his dealings for preferred stock began, but it was not authorized to issue or sell preferred stock at all.

2nd: That the company never had but $100,000.00 of common stock, which at one time was fully paid, but which, at the time of initiating the transaction under consideration, had been entirely depleted so that there was no stock whatsoever, fully paid, as will hereafter more fully appear.

3rd: That while petitioner believed and was induced to believe that he was procuring stock in Morris Brothers, Inc. (the original company)—a prosperous, going concern—he was delivered stock in Morris Brothers, Inc. (a new corporation) which was insolvent at the date of its incorporation, and at all times thereafter.

4th: That no stock whatsoever of the new corporation was ever paid for in money or in money’s worth, unless with the money of claimant and other defrauded parties.

5th: That the pretended "dividends" paid upon the interim certificates and preferred stock in the new corporation were not dividends at all, and that the new corporation never had any surplus or moneys from which to pay any dividends, but that such pretended "dividends" were paid to claimant and other holders of such preferred stock, to further the fraudulent scheme alleged in the petition.

It was shown that these false representations were made in accordance with information furnished the solicitor by John L. Etheridge, president and managing head of the corporation, and it was further shown in corroboration of the authority given the solicitor to make such statements, that the same representations were being made to other persons by John L. Etheridge directly and in person. Smith relied upon these false representations and paid to Morris Brothers, Inc., $2,000.00, supposing that he was making a purchase of that amount par value of preferred stock of Morris Brothers, Inc., having paid up capital from common stock of $500,000.00, which would be an equity supporting and giving security and value to the preferred stock. Smith also supposed that the stock he was buying was stock of the old Morris Brothers, Inc., with which he had previously had dealings and that Fred Morris was connected with the management thereof. It appeared, however, and was first disclosed after the bankruptcy that Fred Morris, while ostensibly connected with the corporation, was in fact no longer a stock-

holder and did not participate in the management. It further appears that on February 21st, 1919, the liabilities of the corporation already exceeded its assets and in addition thereto on that day the entire paid-up capital of $100,000.00 previously existing was depleted and rendered valueless, because on that day Fred S. Morris and Henrietta A. Morris, holding all of the stock of the corporation except nominal and qualifying shares, withdrew assets representing all of the capital stock which ever had been paid up in the corporation to the value of one hundred thousand dollars ($100,000.00), and that this was done by the corporation providing one hundred thousand dollars ($100,000.00) to be used by Stella M. Etheridge in purchasing the capital stock of Fred S. and Henrietta A. Morris, that this transaction had been carried out with guile and secrecy, and was concealed from appellant Smith, and all other persons similarly situated. The corporation was thus rendered insolvent to a still greater extent, and that from said date the concern never was solvent, even to the date of the bankruptcy proceedings now pending.

It appears that on September 6, 1919, and some time after the spurious sale of preferred stock to the claimant, Morris Brothers, Inc., went through the form of dissolving the old corporation and filing new articles under the identical name, providing for an authorized capital stock of five hundred thousand dollars ($500,000.00) common stock and five hundred thousand dollars ($500,000.00) preferred stock, and that all of the common stock except two qualify-

ing shares of one hundred dollars ($100.00) each was subscribed by Stella M. Etheridge, and that all of the preferred stock, without exception, was subscribed by Stella M. Etheridge; that the other officers and directors, Forbes B. Pratt and John L. Etheridge, remained the same in the new company as in the old; that the corporate purposes were the same; that no payment of stock subscriptions of the new corporation was made except by a resolution adopted by the old corporation and by the new corporation, whereby the assets and business of the old corporation were taken over by the new corporation at a valuation of one million dollars ($1,000,000.00).

It further appears that the books of account of the old corporation were continued without interruption as the books of the new corporation until about January 1, 1920. It is clear, also, not only that no attempt was made to actually furnish any new capital on reorganization as representing the common stock, but that Stella M. Etheridge was a dummy subscriber, and that she had no means which could be relied upon for any part of her subscription, and if she had anything whatever aside from her holding stock of the old corporation she was not advised of it, but said on the witness stand that she did not know what, if any, property she had, due to the fact that her husband had handled property under her name, and that she knew nothing of business, and that in all matters she had merely signed such papers as her husband had told her were to be signed.

On or about January the 13th, 1920, a certificate of preferred stock was delivered to claimant Smith, but Smith was still under the effects of the original misrepresentation, was without further information or means of knowledge as to the condition of the company, and had not learned of the falsity of any of the representations made to him; had, on the contrary, been further deceived by being paid pretended dividends exceeding the amount called for by his preferred stock and while he held only an interim certificate therefor, which "dividend payments" were made when Morris Brothers had no profits or surplus out of which to pay the same, but was, as stated, continuously insolvent. **Smith had no vote or participation in the affairs of the company, as the certificate of stock delivered to him, deprived him of that right, nor had he any knowledge of the true state of facts, nor reason to suspect any of the facts were not as represented to him.**

Morris Brothers, Inc., after obtaining Smith's money by fraud and misrepresentation, as aforesaid, dealt with the same as follows, which is the basis of appellant's claim that it is possible to trace and identify, in the hands of the Trustee, property which represents the proceeds of these ill-gotten gains. Whenever a sale occurred of this fictitious stock to the various defrauded purchasers, including Smith, a distinct ledger account was credited with the sums so realized under the heading "Morris Brothers' Preferred 6's." The item of credit arising from Smith's transaction is identified.

On January 12, 1920, the credit arising from these sales amounted to one hundred two thousand, two hundred dollars ($102,200.00). Mrs. Etheridge, being the nominal subscriber and holder of all of the preferred stock of the new or second corporation, was ready to and did turn back to the corporation exactly sufficient shares of preferred stock to satisfy the sales to customers, and the amount realized up to that time and standing to the credit of "Morris Brother's Preferred 6's," to-wit, one hundred two thousand, two hundred dollars ($102,200.00), which included claimant's two thousand dollars ($2,000.00), was credited to Stella M. Etheridge, who promptly withdrew bonds in satisfaction thereof, which bonds are described in Smith's amended claim and petition, and were surrendered by John L. and Stella M. Etheridge to the Trustee, and said bonds, or the proceeds thereof, are admittedly now in the possession of the Trustee and under the control of this court, and the amount thereof exceeds the amount of preferred stock fraud claims, the entire preferred stock claims being now sixty-four thousand, five hundred dollars ($64,500.00).

The decree of the Honorable District Court was as follows:

"On consideration whereof, it is now ordered and adjudged that the order of the Referee in disallowing and denying the claim of the petitioner as a preferred claim is hereby affirmed.

And it is further ordered, however, that the order of the said Referee in disallowing said claim entirely

be and the same is hereby modified, and it is ordered and adjudged that the petitioner's claim in the sum of $2,000.00, with interest thereon from the 31st day of July, 1919, at the rate of 6 per cent per annum, less $146.67, be allowed, subject, however, first, to the payment in full of the claims of general creditors and all other claims filed and allowed against said estate, excepting only those of the nature of petitioner's claim, and it is further ordered that no part of petitioner's claim be paid until said other claims have been paid in full."

ERRORS ASSIGNED.

The errors assigned (Transcript of Record, page 54) are the following:

1. That the United States District Court for the District of Oregon erred in not decreeing to claimant a lien for the amount of his claim against and upon the specific assets or proceeds thereof described in his claim and petition as prayed for by said claimant, and in affirming the Referee's order denying such lien.

2. That the United States District Court for the District of Oregon erred in decreeing that the claim allowed petitioner be subordinated to the payment in full of the claims of general creditors.

ARGUMENT.

The questions actually involved in the appeal are:

First. Do the facts shown by appellant constitute a tracing or identification of trust funds, the trust arising ex maleficio and the identification resting upon the segregation of assets in the manner stated?

Second. The appellant having been awarded his claim against the bankrupt estate, but being denied his lien on specific assets, is he entitled to share equally with other creditors or is he subject to being placed in a deferred class and postponed in payment to other general creditors?

In order to present properly these two questions, it will be necessary to state rather completely but briefly the theory upon which appellant's claim is based, even though it involves a restatement of propositions favorably held by the Honorable District Court. For, while the District Court reached the conclusion that appellant Smith was entitled to have his claim allowed, and thereby classed him as a creditor and not a stockholder, the Court denied him the logical and necessary consequence of that decision by ordering a discrimination against his claim in the payment of dividends. In making this discrimination the Court acted upon reasons which were urged against any allowance of the claim, but which when the claim was once allowed, could have no proper application because of the fixed rule of distribution provided by the Bankruptcy Act. Since no appeal has been taken by the trustee, the allowance of the claim is beyond controversy. Our statement of the grounds and authorities for the claim's allowance is for the purpose of showing how the Court came to a correct decision on the real issue and yet lapsed into error in the decree. The appellant presented his claim, relying upon the following propositions:

First: That the fraud whereby his property was acquired by the bankrupt corporation charged the corporation with the obligation to return the same, which could be enforced by the so-called equitable action of money had and received.

Second: That such a claim for money had and received, though arising out of fraud, yet not being a claim for damages, is provable in bankruptcy, and if the claimant fails to trace the property under a constructive trust the claim would, nevertheless, be allowable as a general claim.

Third: That the fraud committed by the bankrupt in this case impresses a constructive trust upon the property obtained from the claimant.

Fourth: That claimant has traced and identified the property in which the trustee's estate is enriched by the fraud committed upon claimant and others in like situation, and is entitled to have repayment out of the proceeds thereof prior to general creditors.

Liability for Money Had and Received.

The nature of the liability for money had and received arising out of a tort as distinguished from a claim for damages is well stated in Vol. III, Street's Foundations of Legal Liability, pages 199-200, as follows:

> "On general principle the rule is, that whenever one person commits a wrong or tort against the property of another, with the result of benefiting his own estate, the law will, at the election of the party injured, impose a contractual duty on the wrong-doer to pay the party injured the full value of the property appropriated; and this

duty may be enforced by the action of indebitatus in some of its forms. The proposition just stated indicates the point beyond which the fiction of contract cannot be indulged. No form of indebitatus will lie to recover damages for a merely destructive trespass. It is essential that there should be an unjust enrichment of the estate of the tortfeasor."

The same author, in Vol. III, at page 193, quotes from Lord Mansfield's opinion in Moses vs. Macferlan, 2 Burr. 1005, as follows:

> "This kind of equitable action, to recover back money, which ought not in justice to be kept, is very beneficial, and therefore much encouraged. It lies only for money which, ex **aequo et bono**, the defendant ought to refund. . . . But it lies for money paid by mistake; or upon a consideration which happens to fail; or for money got through imposition (express or implied), or extortion, or oppression, or an undue advantage taken of the plaintiff's situation, contrary to laws made for the protection of persons under those circumstances. In one word, the gist of this kind of action is, that the defendant upon the circumstances of the case is obliged by the ties of natural justice and equity to refund the money."

It will be sufficient on this point to cite:

14 Corpus Juris, 593;
Wagner v. U. S. National Bank, 63 Or. 299;
Bradley v. Poole, 89 Mass. 169;

Woodward v. Groner, 89 Am. Dec. 477;
Hamilton v. Bean Co. (Mich.), 121 Northwestern, 731;
Mack v. Latta, 178 N. Y. 525;
Schierenberg v. Stephens, 32 Mo. App. 314;
Pimental v. San Francisco, 21 Calif. 351.

In the case of Wagner v. U. S. National Bank, supra, the Oregon Court explains the manner in which things other than money, to-wit, checks and whatever is accepted and regarded as a money credit will support the action.

It is clear that Smith, when his money was obtained by Morris Brothers, did not become a stockholder, because **there was and could be no such thing in existence as preferred stock in such corporation, and his money having been obtained through fraud and imposition, he was entitled to recover the same in the form of money had and received.**

Such Claim is Provable in Bankruptcy.

It is established law that a claim for money had and received, based as it is on a quasi contract, is a provable debt against a bankrupt estate, and the fact that it originates in fraud whereby the bankrupt obtains the claimant's money does not prevent its being a provable debt. The Supreme Court of the United States has so held in a case where a broker had sold a customer's stock and converted the proceeds and by falsely representing they were still carrying the stock, obtained from him further sums of money. The Court says:

> "We are clear that the debt of the plaintiff is embraced within the provision of Par. a (Sec. 63 of Bankruptcy Act) as one 'founded upon an open account or upon a contract express or implied,' and might have been proved under Par. 63 a had plaintiff chosen to waive the tort, and take his place with the other creditors of the estate." Crawford v. Burke, 195 U. S. 176; 25 Sup. Ct. 9; Schall v. Camors, 251 U. S. 239; 40 Sup. Ct. 135; Reynolds v. N. Y. Trust Co., 188 Fed. 611; 26 Am. B. R. 698; In re Arnold, 133 Fed. 789; 13 Am. B. R. 320; In re Filer, 125 Fed. 261; 5 Am. B. R. 582.

Nor is the fraud which was practiced upon the claimant here any different in character from the fact that it related to a proposed sale of stock to him. There was no such thing as the stock referred to, nor did he ever become in fact a stockholder, or waive any rights, or estop himself in any manner from making this claim. For at the time the pretended certificate of stock was delivered to him in January, 1920, he still knew nothing of the facts, nor of the deceit which had been practiced, nor was the pretended stock certificate even in the same company he supposed he was dealing with, nor in a company in which the conditions were as represented. It is not shown that any credit was given to Morris Brothers by any person now a creditor of the bankrupt estate with knowledge that this pretended stock had been sold to Smith, but on the contrary, the corporation was posing as a one-million-dollar

($1,000,000.00) corporation, and its representations to the public did not descend to such small details as the persons and amounts involved in these fraudulent stock sales. Neither is this a case in which a person was induced to become a stockholder in a corporation which thereafter became insolvent, for here the insolvency existed all the time involved in our inquiries. If any discrimination then be made against the claimant, subordinating his claim to that of general creditors, such discrimination must be an illogical one based upon the kind of spurious paper handed him by the bankrupt. Such a discrimination would mean that the bankrupt, by handing him a white slip in defrauding him, places him in the rank of general creditors, while in handing him a yellow slip it places him in a new class of creditors who may be termed debarred creditors. (For in bankruptcy a creditor postponed till all general claims are paid in full, will always receive nothing.)

The principle is the same as when a corporation takes subscriptions to unauthorized stock. Such subscriptions are absolutely void, and cannot be collected against the subscriber, even though the stock is afterwards authorized. If the stock be issued, it gives neither the rights nor liabilities of stockholders, and if the stock be paid for, the holder becomes a creditor for money had and received, and not a stockholder.

14 Corpus Juris, 530;

Schierenberg v. Stephens, 32 Mo. App. 314;

Anthony v. Household Sewing Machine Co.,

16 R. I. 571;
Scovill v. Thayer, 105 U. S. 143;
Grangers Insurance Co. v. Kamper, 73 Ala. 325;
Clark v. Turner, 73 Ga. 1;
Marion Trust Company v. Bennett, 169 Ind. 346; 82 Northeastern, 782;
Kampman v. Tarver, 87 Tex. 491;
Independent Storage Co. v. Iowa Merc. Co., 179 N. W. 157.

In England, influenced largely by the Companies' Act, which requires a public register to be kept of the stockholders of companies so that the public may know upon whose liability they are relying in dealing with a corporation, it has been held that after bankruptcy or insolvency proceedings the status of a stockholder is fixed, and he cannot then rescind or change his position, even though he may have been induced to become a stockholder by fraud. But in the United States each case depends upon its own facts, and bankruptcy proceedings or other insolvency proceedings are not an absolute bar, but the questions involved are the questions of whether the stockholder has participated in the management, or by laches lost the right to rescind, or whether credit has been given to the corporation by persons relying upon his being a stockholder. And though some American cases say that bankruptcy is a bar, careful examination shows that the other grounds were

always present.

People v. California Safe Deposit Co., 19 Cal. App. 414; 126 Pac. 516;

Johns v. Coffey, 74 Wa. 189; 133 Pac. 4;

Stufflebeam v. DeLashmutt, 83 Fed. 449 (Oregon District, Judge Bellinger);

Newton National Bank v. Newbegin, 74 Fed. 135;

Merrill v. Florida Land Improvement Co., 60 Fed. 18;

Florida Land Improvement Co. v. Merrill, 52 Fed. 77.

The Honorable District Court in the case at bar reviewed the reasoning of the cases in which participation in the management, laches in discovering the fraud or in acting after its discovery, and incurring of indebtedness by the corporation while the party was a stockholder, are given as grounds for denying relief to a defrauded stockholder on the basis of estoppel and quoted particularly from Newton National Bank v. Newbegin, 74 Fed. 135, 140, as follows:

> "There are obvious reasons why a shareholder of a corporation should not be released from his subscription to its capital stock after the insolvency of the company, and particularly after a proceeding has been inaugurated to liquidate its affairs, unless the case is one in which the stockholder has exercised due diligence, and

in which no facts exist upon which corporate creditors can reasonably predicate an estoppel. When a corporation becomes bankrupt, the temptation to lay aside the garb of a stockholder, on one pretense or another, and to assume the role of a creditor, is very strong, and all attempts of that kind should be viewed with suspicion. If a considerable period of time has elapsed since the subscription was made; if the subscriber has actively participated in the management of the affairs of the corporation; if there has been any want of diligence on the part of the stockholder, either in discovering the alleged fraud, or in taking steps to rescind when the fraud was discovered; and, above all, if any considerable amount of corporate indebtedness has been created since the subscription was made, which is outstanding and unpaid,—in all of these cases the right to rescind should be denied, where the attempt is not made until the corporation becomes insolvent. But if none of these conditions exist, and the proof of the alleged fraud is clear, we think that a stockholder should be permitted to rescind his subscription as well after as before the company ceases to be a going concern."

The above quotation should be read in the sense of the early portion, to-wit, "Unless the case is one in which the stockholder has exercised due diligence, and in which **no facts exist upon which corporate**

creditors can reasonably predicate an estoppel."

Now the only basis of estoppel depending upon the incurring of indebtedness while claimant was a stockholder would be that the creditors relied upon claimant as a stockholder. But as appears from the statement of the evidence, there is no evidence to show that any creditor of the corporation knew of the transactions by which Smith received the preferred stock, or of his holding preferred stock, until after the bankruptcy. (Transcript of Record, p. 88.)

The Court expressly acquits us of laches, and so far as it concerns vote or voice in the management, the terms of the preferred stock certificate already quoted shows that was forbidden.

If it be held that the technical status of a stockholder attributed to Smith is a just basis for discrimination against him in favor of ordinary creditor claimants, then our position is that Smith never was a stockholder. We have at all times maintained that Smith never became a stockholder at all, even as a voidable status. Let us consider for a moment that question. First, it is too clear to admit of doubt and is not controverted by the trustee that he did **not become a stockholder at the time his money was fraudulently obtained from him; that he could not have become a stockholder at that time, for the reason that there was no such stock in existence or possible to be created.** The attempt to purchase or the attempt to subscribe equally would have been absolutely void. Therefore, on the 31st of July, 1919, Morris Brothers, Inc., the old corporation, fraudu-

lently obtained Smith's money, and thereby became charged as trustee ex maleficio with that sum. That situation could not be changed, unless by Smith's waiving his rights, or doing something which would estop him or act as a satisfaction of his claim. No delivery of stock which was different from that represented would have waived Smith's rights, unless with full knowledge of the facts on his part. Nor if Smith furnished his money for the purchase of one kind of stock, or the stock of one particular company, would the substitution of stock in another company without his knowledge make him a stockholder. When Morris Brothers, Inc., received Smith's money it was the old corporation. It was in that corporation, even misrepresented as it was, that Smith supposed he was buying stock. That corporation was dissolved afterward, and it became absolutely impossible that preferred stock of that corporation ever could be delivered. When a stock certificate was finally delivered to Smith, he had no knowledge as to any of the facts misrepresented, and also did not know that it was stock in a different corporation entirely which was represented by the certificate delivered to him.

> "There is no agreement where one party enters into the contract under a mistake as to the identity of the other party, as where the party contracted with has falsely represented himself to be another, or has accepted an offer meant for another."

13 C. J. 378 (paragraph 266), and numerous cases there cited, among which are:

Consumers Ice Co. v. Webster, 32 App. Div. 592; 53 N. Y. S. 56;

Boston Ice Co. v. Potter, 123 Mass. 28; 25 Am. R. 9;

Fitzpatrick Building Co. v. Healy, 120 Minn. 237; 139 N. W. 495;

Boulton v. Jones, 2 H. & N. 564; 157 Reprint 232.

For the foregoing reasons the delivery of the bogus stock certificate to Smith did not make him a stockholder, whatever might have been the case if actual authorized stock in the original Morris Brothers, Inc., had been delivered to him, or if he had knowingly accepted stock in the second corporation. Accordingly, there is no prayer for rescission in our petition, but we do offer the worthless paper to be cancelled and we do offer to return the pretended dividends paid us, but this is merely an offer to do equity under the particular circumstances set forth in our claim. The fact of such offer seems, by the opinion rendered, to have been overlooked by the Honorable District Court, who says such offer was not made. The offer appears in the petition (Par. 18, Transcript of Record, page 17) and in the evidence (Transcript, pages 89-90). If rescission were involved, however, it could be granted without a specific prayer.

Error in Denying Participation in Creditors' Dividends.

We have discussed the merits of appellant's claim to be entitled to the position of a creditor in order to show that appellant is justly entitled to stand as holder of an allowed claim on an equal footing with other general creditors. The Honorable District Court allowed our claim but erroneously, we say, ordered that no dividends should be paid upon this claim until all general creditors, except those having claims of the same nature, should be paid in full. The Court thus created a classification of claims not recognized or countenanced by the Bankruptcy Act, thus holding that we are creditors who are not entitled to any payments.

The Bankruptcy Act, in Section 66, provides for the priority of certain classes of expenses and claims with their order of payment. Section 67 (a) of the Act reads as follows: "Dividends of an equal per centum shall be declared and paid on all allowed claims except such as have priority or are secured."

Here we have a direct and unequivocal provision which requires that all persons who have claims allowed, unless they are among those entitled to priority, shall be treated equally and there is no provision in the Act positive or permissive contemplating any discrimination among general claimants. On the contrary, such discrimination is also forbidden by Section 67 (e), which reads as follows: "A claimant shall not be entitled to collect from a bankrupt estate any greater amount than shall accrue pursuant to the provisions in this Act." If all other gen-

eral creditors were paid in full in preference to Smith, then every one of them would receive more than would accrue to him pursuant to the provisions of the Act. So we have both a positive and a negative provision designed to protect an allowed claim from discrimination.

The Bankruptcy Act establishes an arbitrary system upon reasons of policy. It discharges the bankrupt debtor from his just obligations and it distributes his estate according to a fixed plan and order of distribution and it leaves no room for a court, either of legal or equitable jurisdiction, to make new classifications of creditors or to dispense with or relieve against the positive provisions of the statute. We maintain, therefore, first, that the allowance of appellant's claim, not appealed from by the trustee, was well justified by the law and the evidence; second, that portion of the decree allowing the claim which provides that it should not receive dividends until after the payment of other general creditors in full is erroneous and should be modified in that respect.

Fraud As a Basis for Constructive Trust.

Having shown that appellant Smith is entitled to be considered at least as favorably in regard to payment of his claim as any other general creditor, we will now discuss the grounds upon which he is entitled to have his claim paid out of the particular funds into which his money can be traced before any part of that specific fund is applied to the payment of other claims.

The effect of fraud in creating a constructive trust, or trust ex maleficio, is clearly stated in Perry on Trusts, (6th Ed.), Par. 166:

> "There is another large class of trusts which arise from frauds committed by one party upon another. Thus, if one party procures the legal title to property from another by fraud or misrepresentation or concealment, or if a party makes use of some influential or confidential relation which he holds toward the owner of the legal title, to obtain such title from him upon more advantageous terms than he could otherwise have obtained it, equity will convert such party thus obtaining property into a trustee. If a person obtains the legal title to property by such arts or acts or circumstances of circumvention, imposition, or fraud, or if he obtains it by virtue of a confidential relation and influence under such circumstances that he ought not, according to the rules of equity and good conscience as administered in chancery, to hold and enjoy the beneficial interest of the property, courts of equity in order to administer complete justice between the parties, will raise a trust by construction out of such circumstances and relations; and this trust they will fasten upon the conscience of the offending party and will convert him into a trustee of the legal title, and order him to hold it or to execute the trust in such manner as to protect the rights of the defrauded party and promote the safety and inter-

ests of society. Such trusts are called constructive trusts. . . . In all such cases the relief is really founded on fraud and not on constructive trust. When it is said that the person who fraudulently receives or possesses himself of trust property, or who has defrauded another of his estate by misrepresentation, concealment or other fraudulent practices, is converted by the Court into a trustee and ordered to account for or to reconvey the property, the expression is used for the purpose of describing the nature and extent of the remedy against him, and it denotes that the parties defrauded or beneficially entitled have the same rights and remedies against him as they would be entitled to against an express trustee who had fraudulently committed a breach of the trust."

Pomeroy in stating the same doctrine (Eq. Juris 4th Ed., Par. 1044) says:

"Courts of equity, by thus extending the fundamental principle of trusts—that is, the principle of a division between the legal estate in one and the equitable estate in another—to all cases of actual or constructive fraud and breaches of good faith, are enabled to wield a remedial power of tremendous efficacy in protecting the rights of property; they can follow the real owner's specific property, and preserve his real ownership, although he has lost or even never had the legal title, and can thus give remedies far more

complete than the compensatory damages obtainable in courts of law. The principle is one of universal application; it extends alike to real and personal property, to things in action, and funds of money."

In Par. 1047 of the same work it is said:

> "By the well settled doctrines of equity, a constructive trust arises whenever one party has obtained money which does not equitably belong to him, and which he cannot in good conscience retain or withhold from another who is beneficially entitled to it; as, for example, when money has been paid by accident, mistake of fact, or fraud, or has been acquired through a breach of trust, or violation of fiduciary duty, and the like."

See also same author, Par. 1053.

This doctrine is so universal in courts of equity that there is no occasion to multiply authorities. By the Oregon Supreme Court it is clearly stated and explained in the cases of

Parrish v. Parrish, 33 Or. 486, 490, et seq.;
Springer v. Young, 14 Or. 280, 283;
Clough v. Dawson, 69 Or. 52.

By the U. S. Supreme Court it is recognized in many cases, among which are:

Moore v. Crawford, 130 U. S. 122; 9 Sup. Ct. R. 447;
Wheeler v. Sage, 1 Wall. 518;
Angle v. Chicago R. Co., 151 U. S. 1; 14 Sup. Ct. R. 240;
Felix v. Patrick, 145 U. S. 317.

Within this doctrine, when Morris Brothers obtained claimant Smith's money by fraud and misrepresentation, they became charged with responsibility for the same as a trust fund, and the creditors of Morris Brothers are not entitled to have the benefit of Smith's money or the money of others obtained under the same circumstances, for the reason that it is not property which in equity and good conscience belongs to Morris Brothers, and which could be used by them for the payment of their own debts.

See also the interesting case arising out of the Ponzi frauds, Lowell v. Brown, 280 Fed. 193.

And then we come to the consideration of the extent to which it is necessary that the claimant identify or trace the trust property. We claim we have met this test, and that the District Court erred in holding otherwise.

Claimant Has Identified the Property Which Now Represents What Was Fraudulently Obtained From Him.

The power which the court has of restoring trust property to its rightful owner depends upon it being possible to identify the property. It is not, however, necessary that the property shall have remained in the same hands, as it can be followed so long as it can be traced, unless it come into the hands of an innocent purchaser for value. Cestui que trust is entitled to the property, even though its form be changed, and he may claim it in the form of proceeds of sale or exchange, and the only requisite is that he

can show what property now represents the trust property. In identifying the trust property it is not necessary that the objects which constitute the property be identical; for instance, it makes no difference whether money is received in coin, check, or the equivalent, nor does it matter that the money passes into a credit with the banker, title to the money itself being lost. A check drawn upon such bank and issued for the purchase of real or personal property would be a conversion of the trust fund into such property, and the trust would then attach to the newly acquired property. It is therefore not necessary that the funds be traced with literalness, but it must be shown that the trust property now exists in its original or a substituted form, and that it constitutes the whole or a part of some particular property or fund within the jurisdiction of the Court. In the present instance, it was shown beyond doubt that Smith's money was obtained by fraud, and that the purpose for which it was received and to which it was to be devoted, together with the other moneys received in like manner, was shown and preserved on the books of account of the corporation in a ledger account, to the credit of "Morris Brothers Preferred 6's"; that the formality of subscription of preferred stock by Stella M. Etheridge was performed, and that from Stella M. Etheridge was received the surrender of the necessary stock for delivery to plaintiff and the others, and in ostensible payment therefor Stella M. Etheridge received from Morris Brothers bonds representing the full amount of the stock

so surrendered for delivery to plaintiff and other persons defrauded in like manner; that these bonds were afterward surrendered to the trustee. In short, Morris Brothers received our money for preferred stock, and turned over an equivalent amount of bonds to Mrs. Etheridge in the acquisition of such preferred stock, and, it appearing that the stock was fraudulent and fictitious, claimant is entitled to the fruits of the transaction found in the hands of Mrs. Etheridge, and surrendered to the trustee. Had Mrs. Etheridge been paid in cash and immediately spent the cash in buying these bonds, the result would have been the same, for the cash paid her by Morris Brothers would have represented our money, and this, notwithstanding any fluctuations in Morris Brothers' cash on hand, or any confusion or depletion of funds of Morris Brothers which might have occurred.

It does not affect our rights that the payment was made to Mrs. Etheridge by giving her a credit which she immediately used in the purchase of these bonds. In the case of Schwartz v. Gerhardt, 44 Or. 425, a constructive trust was declared and enforced in reference to a piece of property which was purchased with trust funds, and there was no attempt to show in what form the funds had been received, nor what changes had taken place therein, but it was shown to the satisfaction of the Court that the trustee was not in a financial condition to have made the purchase of property except by the use of the funds wrongfully converted.

The Court says:

> "The principle is, the fund in trust does not lose its identity, although it may change in semblance, and whatsoever form it may have assumed the trust attaches still, whether it remains in the hands of the original trustee or has gone into other hands, especially if the latter has taken with notice of the trust relations."

It has further been held by the Supreme Court of Oregon that where the trust fund is traced into a larger mass, of which it forms a part, then the rightful owner may be protected by charging a lien upon the property which includes the trust property. The Court says:

> "But whether such owner seeks to recover such specific property, or to create a lien upon a mass or fund, he must trace such property and show that it belongs to him, or that it has gone into and then remains in the mass which he seeks to impress with a lien or charge. In such case, the question to be determined always is, whether the trust property or fund, or the proceeds thereof, is traceable into any specific property or fund. Before, therefore, one claiming to be a trust creditor can be entitled to a lien or preference over other creditors, he must make it appear that the fund or property of the debtor which he seeks to affect with such lien or preference includes the trust property, or the proceeds thereof. 'If it appears,' said Andrews, J.,

'that trust property has been wrongfully converted by the trustee, and constitutes, although in changed form, a part of the assets, it would seem to be equitable and in accordance with the equitable principles, that the things into which the trust property has been changed should, if required, be set apart for the trust, or, if separation is impossible, that priority of lien should be adjudged in favor of the trust estate for the value of the trust property or funds, or proceeds of the trust property, entering into and constituting a part of the assets: Cavin v. Gleason, 105 N. Y. 262, 11 N. E. 504.'"

Ferchen v. Arndt, 26 Or. 121, 128.

In the case at bar we have such an instance. The bonds which were appropriated by Morris Brothers to the purpose of paying Mrs. Etheridge for the preferred stock to be delivered to us, and which are now identified in the hands of the trustee, aggregate one hundred thousand dollars ($100,000.00) par value; whereas, certain of the defrauded preferred stock purchasers were repaid prior to bankruptcy adjudication, so that there now remain outstanding claims of this character for $64,500.00. It is, therefore, a case in which the claimant, with others showing themselves in like situation, should be awarded a lien upon these bonds, or their proceeds; that the bonds should be ordered sold by the trustee, and all of the proceeds remaining after the satisfaction of preferred stock fraud claimants would be available for dividends to general creditors.

In further confirmation of the propriety and sufficiency of our evidence tracing and identifying the trust property, we quote from Perry on Trusts, Par. 828:

> "A trustee need not have bought the property with the very dollars received by him in trust; if he uses or loses the trust dollars and substitutes others the latter become impressed with the trust. And the better opinion on authority now is that, even as to creditors, the mixing of trust funds with private in a general deposit does not obliterate the trust."

And from the same author, Par. 841, we quote:

> "There may be some difficulty, as a matter of fact, in tracing the trust property into a purchase made by trustee. Thus if a trustee having money in his hands, misappropriate the funds and afterwards purchase lands in his own name, it may be difficult to show that the land was purchased with the trust money; and if the trust money, or its proceeds cannot be traced into the lands, the cestui que trust cannot have a lien on them. But, if the money can be traced through all its other forms the law is plain; and the cestui que trust can claim the land. Parol evidence is admissible to show all the transactions made with the trust money. Thus the fact that the purchase money nearly corresponds with the trust fund to be invested, is important. So, if by a check or other means it can be shown

that the trust money was drawn to pay the purchase money, there can be no doubt. If a trustee makes a sale of one estate and purchases another at the same time, or shortly afterward, it will be presumed to be one transaction, although the purchase money of the estate purchased was larger than of the estate sold, and the cestui que trust will have a lien on the estate for the amount of the trust fund paid toward the purchase. So, if a trustee is under obligation to lay out a sum of money in land, and he purchases an estate at a price corresponding with the sum to be invested, the Court will presume that the purchase was made with trust money."

And from the same author, at Par. 844, we quote:

"If a trustee whose duty is to hold certain shares of stock until demanded sells the shares in violation of the trust, the cestui can in equity hold other shares of the same company belonging to the trustee to replace the trust stock, and this even when the trustee's estate is insolvent."

See also Duel v. Hollins, 36 Sup. Ct. 615, a bankruptcy case. And the author cites Draper v. Stone, 71 Me. 177, where the subject is discussed at some length, and In re Brown, 171 Fed. 254, where it is held to the same effect, the ground being that it is presumed that other stock of the same kind is held or acquired as a replacement of the trust stock, the Court cites the analogous case of an agent who depletes a bank account in his name, as agent, and

says:

> "Subsequent deposits in that fund would go to make good the former conversion, and the general creditors could not complain. Baker v. Bank, 100 N. Y. 31; 2 N. E. 453; 53 Am. Rep. 150. He may make good his default out of his own property, and all that is necessary is an unequivocal appropriation of the property to that effect."

To the same effect:

In re McIntire, 181 Fed. 960;
In re Smith, 278 Fed. 844;
Eby v. Waltz, 286 Fed. 924.

Again, it is held in Houghton v. Davenport, 74 Me. 590, that if a trustee mingles trust money with his own and afterwards separates a proper portion from the common fund as the property of the cestui que trust, and with such portion then purchases real estate in his own name, the trust is impressed upon such money and upon the land so purchased.

To return to the case at bar,—if at any time after receiving our money Morris Brothers confused it with other funds, or even expended it, nevertheless, the money being received on account ~~by~~ of the preferred stock and equivalent property being afterward used ostensibly in the acquisition of ~~its~~ this preferred stock, our trust funds are again segregated and identified. The case would be the same if A received money from B for investment, deposited it to his personal account with other funds, giving credit on his books to B and should thereafter purchase a certain bond

and charge the purchase on his books to B's account. It would make no difference that he used his own money in the purchase of the bond, nor that it was drawn from the confused account or from some other source. We believe that the trust fund is traced and identified here just as absolutely.

In the Court below counsel for the trustee seemed to assume that our claim that these specific assets were impressed with the responsibility to answer first, the demands of our trust was based merely on the fact that the bankrupt got the benefit of our money, and the counsel made the point that the corporation had changed its identity, and that the particular money obtained from us may never have gone into the hands of the new corporation. This is quite aside from the question. The Court remembers how this account was carried on the books of Morris Brothers, Inc., and how the new corporation, having the same officers as the old, continued the same books and made the entry turning over to Mrs. Etheridge the accumulated credit derived from preferred stock sales. The new corporation was charged with exactly the same responsibility as the old. It took the benefits, aided in the transaction and was a direct participant in the fraud.

> "If the stockholders of a corporation organize another corporation and transfer all the assets of the former to the latter, without paying the debts of the former, the transfer, irrespective of the actual intent of the parties, constitutes a fraud upon the creditors of the old cor-

> poration and the new corporation is liable in equity for the debts of the old to the extent of the assets received by it; or the assets themselves may be followed by the creditors of the old corporation, so long as they have not passed into the hands of bona fide purchasers for value. This applies with peculiar force where the members of the old corporation and the new are the same persons, or mostly so."

2 Clark & Marshall on Corporations, page 995 (in Sec. 3421).

To the same effect is Corsicana National Bank v. Johnson, 251 U. S. 68, 40 Sup. Ct. 82. The consequence is, that when the officers of the new corporation, being the same individuals who had got claimant's money by fraud, appropriated certain property for use in ostensibly making good the trust, it resulted to claimant's advantage in exactly the same way as if there had been no break in the continuity of corporate existence.

The Honorable District Court took a view favorable to us upon the matter of responsibility of the new corporation, but, as above stated, held that the state of facts and the transaction as set forth, did not constitute an idenification of trust fund which would entitle us to priority for our claim. The Court so held (Transcript of Record, page 45) ~~that~~ upon the ground that for claimant to prevail on this phase of his case, it was necessary that the bonds turned over to Mrs. Etheridge for the acquisition of

this preferred stock should be the same bonds or money parted with by claimant Smith. We do not contend that they were the same bonds, but we submit that the Court has laid down too strict a rule for the following or identification of trust property and that the portion of the decree denying the claimant and others in like situation priority as to said bonds and their proceeds is erroneous and that the decree should be so modified as to give claimant the relief prayed for.

Respectfully submitted,

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Service by three copies accepted this ...... day of August, 1923.

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